The Foundation Payout Puzzle
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June 2001
Working Paper No. 9

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The authors gratefully acknowledge the financial support of NewTithing Group and the Bradley Foundation and the research assistance of Yekiu Kim, Jens Christian Niedermeier, Alexander Villanueva and Jennifer Johnson. We would like to thank Claude Rosenberg, David Scudder, Christine Letts, Mark Moore, and Marion Fremont-Smith for valuable comments on earlier drafts of this paper.

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Abstract

This paper examines public policy toward American philanthropic foundations. We find that the major regulation bearing on foundations -- a mandated minimum endowment payout rate -- has had the effect of repressing foundation giving. Interviews with foundation trustees and presidents point to a number of significant obstacles to proper conceptualization of the payout decision in foundations. In the face of these obstacles, our survey of foundation payout behavior over 25 years reveals that most foundations simply pay out the mandated minimum amount each year, regardless of other relevant considerations. We argue that the minimum rate has gone from being a floor when it was enacted decades ago to a ceiling today. The paper concludes with an exploration of how the payout policy could usefully be reformed.

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At a time when discretionary public funds for new social programs are limited, many current and future public needs may be addressed through initiatives launched and funded within the nonprofit sector. America's 50,000 grant-making foundations are a small but critical part of the nation's growing nonprofit sector. As a group, private foundations control assets of $400 billion and disburse about $20 billion in grants each year to nonprofit service providers. Roughly half of all foundation grants are made by the 300 largest institutions. Foundation giving has come to be counted on as a critical early, and often first, funding source for new and innovative projects in the nonprofit sector. Foundation philanthropy continues to grow in size and is expected to explode as the baby-boom generation ages and declines. Some estimates have projected a $40 trillion transfer of wealth in the coming decades, with huge amounts flowing into foundations.

Against this backdrop, two separate and narrow debates have raged in recent years about foundation grant-making and investment practices. The first debate has focused on finding ways to improve the way foundations make grants and it has asked how to give. The second debate has focused on locating the best financial strategy for the investment of endowment assets and it has asked how to invest. There is, however, a more fundamental question that has largely been ignored, namely how much to give now and how much to save for future giving.

Foundations are known for both their endowments and their grants. One of the few regulations that all private foundations face is a requirement that they pay out of their endowments in the current year at least 5 percent of the average monthly value of their endowment during the previous year. This minimum expected payout includes both grants and administrative expenses associated with operating a foundation. Where did the 5 percent rule come from and what is the logic behind it? During negotiations over the Tax Reform Act of 1969, Congress enacted a set of modest regulations designed to ensure that foundation assets were being productively used for charitable purposes. No systematic research lay behind the payout rate, which was originally set at 6 percent then reduced to 5 percent a few years later. The number remains less a product of economic reasoning than three decades old political bargaining.

The 5 percent rate is a lower limit below which foundations cannot go. However, there is no upper limit on how much they may disburse. The decision about how much to pay out in grants is a critical one because, across the entire foundation field, every one percent increase in the annual payout rate of all foundations translates into approximately $4 billion in new grant funds for the nonprofit sector. Given the stakes that are at issue, foundations must give serious thought to the question of how much should be given away today and how much should be saved for the future. However, pulling at foundations as they deliberate over this complex issue are compelling arguments for a higher payout rate and a strong case for a low payout rate.

This paper begins with a summary of the arguments on both sides of the payout debate. We then draw on a new dataset on foundation financial management to examine what a group of large and influential foundations have resolved the payout decision over the past two and half decades. After finding a remarkable convergence in foundation payout behavior, we explore several possible explanations for this behavior. We conclude by exploring policy alternatives to the long-standing 5 percent minimum payout rule and why a revisiting of this thirty year old public policy is in order.

I. For and Against the Five Percent Payout Rule

Because foundations play a visible and important role in the working of the broader nonprofit sector, their behavior is subject to considerable scrutiny. To date, however, discussion of the payout rate has been limited (Nelson 1987; Steuerle 1977). On the one side, a group of progressive grantmakers sympathetic to the nonprofit service community has actively argued for a higher payout rate based on social justice considerations: "Grants are the primary way philanthropy impacts our society. Grants fund the people and organizations at the heart of building communities, alleviating poverty, and creating change...Social change giving is about reaching those that traditional charities often ignore, but who are in the greatest need of help...We call on our colleagues in the philanthropic community to join our effort by increasing their pay-out to include '1% More for Democracy' to support real social and economic change." (Mehrling 1999). On the other side, studies sponsored by or conducted by the foundation trade associations (Demarche 1999, Council of Michigan Foundations, 2000, Salamon 1991) have simply argued that foundations need to preserve their assets for the future, without saying much more about the trade-offs that such an approach to giving entails. While admitting that a foundation that spent out an additional 1 percent maintained the value of their endowment over the past four decades, these studies often state the obvious, namely that the less foundations spend today the more they will have in the future. The inevitable conclusion of the industry is that caution is in order when it comes to changes in policies or practices. In order to advance this policy debate beyond these narrow political and self-interested positions, we begin by analyzing the underlying issues on both sides of the payout debate.

A. Arguments for a higher foundation payout rate

There are at least five good arguments for high foundation payout rates. They include the possibility of attacking a problem early and before it has become intractable, the desire to achieve greater levels of intergenerational equity, the ability to count on new money entering the field of philanthropy to replace, the need to protect and execute the intent of the donor, and the possibility to diffusing public criticism of foundation avarice by paying out higher levels of grants. We summarize each of these five arguments below.

1. Early intervention: Spending more now will allow foundations to nip social problems in the bud

One potent argument for a high payout rate is related to both effectiveness and efficiency. Giving away larger amounts of money today is attractive because it could make it easier for foundations to actually solve social problems within communities rather than merely treat the symptoms of social disorder. The idea of nipping a problem in the bud rather than waiting years for it to fester has strong intuitive appeal, especially since organized philanthropy has for over a century sought to distance itself from charity and alms giving. To be effective, foundations need to do preventive giving, which involves intervening before problems become so acute that no amount of foundation funding is likely to have much effect. By getting to root causes and by committing large blocks of philanthropic capital in the short run, foundations can in principle avoid having to spend ever larger amounts of money over longer periods of time. In some fields, like medical research, funding work today has considerably more value than funding research 20, 50 or even 100 years from now. Not only will work to find a cure for a disease like AIDS today help a large number of people, but it will also lead to a slowing in the spread of the disease. In New York, feeling that the AIDS issue simply could not wait, Irene Diamond spent most of her large foundation's assets over a ten year period funding path-breaking research in a new AIDS research laboratory she created. Her grants played a critical role in supporting the work of Dr. David Ho who was chosen to lead the new lab and who discovered protease inhibitors, one of the most promising AIDS treatment breakthroughs to date. In cases like this, where problems are likely to grow in the absence of philanthropic interventions, it may be more efficient to act in the present and to pay out large amounts of grants in order to tackle a problem aggressively.

2. Intergenerational equity: Generational benefits ought to roughly equal tax expenditures

A higher payout rate may also make sense if intergeneration equity is a concern. The whole question of foundation payouts touches on serious tax equity issues, especially given the exponential growth in the size of foundation assets expected in the coming decades. Foundations have long represented one of the few alternatives to paying high estate taxes, which now surpass 50 percent on large estates. When a foundation is created today, the burden of lost tax revenue is borne by citizens today in the form of a tax expenditure. However, the benefits of foundation giving largely do not accrue to the taxpayers that make this expenditure for the establishment of foundations today. By giving the wealthy the opportunity to create a foundation in perpetuity, taxpayers today are in essence being asked to subsidize the welfare of future generations, at a time when many current social needs continue to be unmet. This ever-evolving intergenerational transfer of resources would be unproblematic if each generation made tax expenditures of roughly equal size. This is clearly not the case, however. As demographic waves of different sizes and with different levels of resources age and convey their wealth into foundations, the unequal intergenerational distribution of foundation assets will become pronounced. Just as the burdens and benefits of Social Security are not distributed equally across generations, so too will low foundation payouts in perpetuity create intergenerational inequities. Higher levels of giving may be needed to even out the costs and benefits of foundation giving.

3. Projected growth of philanthropy: New money will enter the foundation field to replace what might be spent

Higher rates of giving by foundations appear justified by virtue of the fact that new funds will flow into the foundation field as a whole. Money disbursed by foundations may indeed be lost to endowments forever, but new funds are entering philanthropy through bequests to existing foundations and through the formation of new foundations. For foundations pondering whether higher levels of giving will lead to a long term diminution in the availability of funds, these new institutions offer some reassurance that philanthropy's future is secure. Just in the last five years, two foundations created with technology fortunes have leapt to the top of the list of the largest foundations. As a result of recent infusions of funds, the Gates Foundation and the Packard Foundation, both relatively new entries in the foundation field, now control almost 10 percent of the assets of the entire field. Other substantial fortunes, including those created by the growing ranks of billionaires have been pledged to philanthropy, though the funds have not yet arrived at their final institutional resting places. The availability of these new funds for giving in the future should make higher levels of giving today more appealing.

4. Donor intent: Spending more earlier will allow some foundations to enact donor desires

Because foundations often are established in perpetuity, the issue of how best to protect and pursue the donor's philanthropic intent often arises. Sometimes, donors leave behind very clear instructions about how they want their fortunes to be used. The challenge of enforcing and implementing the donor's philanthropic agenda is usually not a problem if family members are on the board who knew the donor. Over time, however, as outside directors join the board and as succeeding generations get involved with philanthropy, protecting and pursuing the donor's intent can become difficult. While there is considerable debate over whether philanthropic intent should be enforced at all, for those who are committed to it, higher payout rates are one way to ensure that charitable funds are used appropriately. The desire to carry out a donor's philanthropic agenda has led some foundations pursue a payout strategy that will eventually lead to the liquidation of assets. Both the Astor Foundation and John M. Olin Foundations in New York decided to pay out large amounts in order to ensure that the donor or a close friend of the donor was able to maintain control over the funds and apply them to causes that fit the original charitable intent of the founder. While this is an extreme position, many donors have begun to do more of their giving while alive simply because they want to enjoy their giving and see their interests and aspirations fulfilled. For such donors, a higher payout rate represents a tool for ensuring that philanthropic resources are allocated according to their desires.

5. Legitimacy: A higher payout rate will curtail criticism from the nonprofit sector and government

The legitimacy of the foundation field is at stake in the payout debate. With the huge amounts of money they control, foundations are easy targets for criticism. Criticism from activists within the nonprofit sector has been mounting, with several associations and research groups raising questions over the generosity of foundations. By paying out the bare minimum required by law, the largest foundations have created conditions not dissimilar to those thirty years ago when the field was first investigated and regulated by Congress. The Tax Reform Act of 1969 contained not just the payout rate, but also an excise tax on net investment income, greater disclosure requirements, and a ban on transactions that benefit foundation officers. These measures were enacted because a small number of controversial grants created suspicion and concern about political meddling and mismanagement within the field, concerns that the foundation field failed to address and correct publicly. By paying out grants at a higher rate today, foundations could deflect the mounting criticism of their payout practices and position themselves more effectively as responsible partners within the broader nonprofit sector. In this sense, higher payout rates could be a potent defender of the field's privileges and its long-term independence.

B. Arguments for the current foundation payout rate

There are at least five good arguments for a lower foundation payout rate. They include the realization that social problems may get worse over time, the uncertainty posed by volatile financial markets, the weight of professional experience and tradition, the appearance on the scene of new problems that cannot now be foreseen, and the limitations of nonprofit service organization to absorb effectively sudden increases in funds. We detail each of these arguments below.

1. Exacerbation of current social problems

Some foundations may seek to pay out the minimum required by law in order to conserve their resources for the future when particular social problems may be more acute than today. In areas such global environmental protection, it is hard to see the problem of sprawl, air pollution, and water quality becoming smaller and less challenging in the future. In fact, some foundations might reasonably argue that these areas are likely to grow substantially in their urgency over time and that careful stewardship of funds today is needed to ensure that large amounts of philanthropic dollars are available to address these problems in the future. Compounding the issue of problem exacerbation is the growing perception that many of the most significant human problems cross national boundaries and that philanthropic resources, not public spending, may be needed to address difficult problems that span boundaries and extend out into the distant future.

2. Uncertainty in financial markets

Paying out only the bare minimum of five percent appears quite defensible in light of the uncertainty of financial markets. Almost all foundations have their assets invested in a mix of stocks and bonds, usually split roughly 60-40 between the two. Although many of the largest foundations have invested more heavily in stocks and done very well in recent years, memories of foundation financial advisors are long. In the past, there have been fairly prolonged periods of market decline, particularly in the mid 1970s and late 1980s. During the 1970s, the Ford Foundation saw its assets drop precipitously, as McGeorge Bundy's free spending policy was matched with a down market. Because it is impossible to predict the future of the market, many foundations believe that it is important to pay out the minimum amount to ensure that future volatility does not erode the foundation's endowment. While market declines may hurt foundation endowments in the future, those foundations paying out less in grants will be able to cope with these declines more easily than those that are spending their funds aggressively on grants.

3. Weight of tradition and professional experience

Paying out five percent is attractive because the practice has the weight of tradition and professional experience behind it. The "five percent solution" has been endorsed by large numbers of foundation mangers and trustees through years of practice. Deviating from this established pattern of behavior exposes foundation managers to considerable risk, should the additional funds they wish to expend not achieve their intended purpose. This is particularly problematic given the rise in professional careers in the field of philanthropy over the past three decades and the desire for advancement that accompanies professionalization. For the foundation executive, staying within the confines of the five-percent payout is simply the safest and surest course of action. Among trustees, who play a critical role in setting payout policy, there is also a strong tendency to defer to tradition. Pushing a foundation to adopt a higher payout than the minimum required by law requires overcoming the strong pull of the duty of care, which directs trustees to preserve foundation assets for the future. The tradition of careful and conservative stewardship argues against breaking the mold and seeking to pay out higher levels of grants. For new entrants to the field, the weight of professional experience and tradition is felt through training and orientation programs that allow newcomers to foundation philanthropy to meet and learn from experienced hands. Given the strong networks within philanthropy that are forged by associations and board interlocks, adopting a conservative 5 percent payout rate is surely appealing.

4. Emergence of new and unforeseeable social problems

For foundations pondering the payout issue, the future needs of society may appear hard to know. Over time, foundations with broad charters may discover that new problems will emerge that will require foundation attention that today cannot even be foreseen. Many of the largest foundations are established in perpetuity with very broad missions precisely for this reason. The Kresge Foundation, for example, defines its mission as "to identify, and address at their source, the causes of human suffering and need," while the Rockefeller Foundation simply claims "to promote the well-being of mankind." For foundations with broad purposes established in perpetuity, the idea of spending conservatively in the present seems advisable since it is impossible to predict what needs will emerge and how critical they will turn out to be years into the future. The range of social problems that have emerged over the past century, but that no one could have predicted, is broad enough - from crack cocaine addiction in the U.S. to flesh eating bacteria in Africa - that many foundations now spend carefully on grants in order to build their endowment for the next generation of social problems that may emerge in the future but that are not obvious today.

5. Limited nonprofit capacity and diminishing returns

Spending conservatively on grants today may also appear wise given the limited ability of nonprofit organizations to absorb and use effectively substantially larger amounts of money in a short period of time. The payout decision is not just about the interests and needs of foundations. It has clear practical implications for the broader nonprofit sector, which uses foundation grants to deliver services. For some foundations thinking about the question of achieving their philanthropic purposes, substantially increasing the flow of grants to nonprofits is not an obviously efficient way to increase a foundation's social impact - especially if smaller, local, and less sophisticated nonprofits lack the infrastructure to direct these additional funds to productive uses. Moreover, there is always the question of whether growth and scale are universally desirable ends, with many believing that nonprofit agencies are most effective when they are small and tightly linked to local communities. In some areas of activity, there may well be diminishing returns on philanthropic investments. In the area of public policy advocacy, for example, funding new research and public information

II. Recent Foundation Payout Decisions

Given the compelling nature of the claims on *both* sides of the issue, one might reasonably expect to find foundation payouts distributed fairly broadly across a spectrum ranging from 5 percent all the way up to much larger numbers. All of which raises some basic questions: What exactly have foundations done with their assets over time? How have they set their payout rates? What is the connection between asset growth and higher payout rates?

To answer these questions, we have assembled a first comprehensive and reliable database on the management and use of foundation assets. This database contains financial information on 290 foundations from 1972 through 1996. We included two groups in our sample: To capture the largest and most influential foundations today, one group included the 100 largest foundations, measured in terms of assets reported in 1997. The other group included the 220 foundations that reported assets greater than $5 million in 1970. We collected data on this second group to eliminate a survival bias that might be introduced if we used only the largest foundations today. After eliminating overlaps, we were left with a sample of 290 foundations. Unlike other studies that have relied on imprecise aggregate reports based on voluntary surveys, the data in this study was drawn from I.R.S. Form 990PF, the annual reporting form used by private foundations. This data was collected over a two year period from the I.R.S., nonprofit archives where 990PFs are stored, and the foundations themselves. To supplement this quantitative data, we interviewed 34 foundation trustees, presidents, and financial managers about the payout decision making process.

The data in Figure 1 shows the average payout rate of this sample of foundations over time, as the policy regime has shifted slightly from a flat 6 percent, to the greater of total investment income or 5 percent, to a flat 5 percent. Although there is some change in response to these minor adjustments of policy, the payout decisions of foundations have remained remarkably stable. The data in Figure 2 shows what a sub sample of foundations for which at least 10 years of data was available have done over 25 years. Each stacked pair of squares and triangles depicts the average return rate and payout rate of an individual foundation. The most striking feature of Figure 1 is the consistency of the payout rates and size of gaps between return rates and payout rates. As a group, the foundations in our sample have returned 7.62 percent annually on their assets, while paying out an average of 4.97 percent.

The data in these two figures raise the following questions: Given the tremendous diversity of missions and purposes pursued by foundations, why is there such a high level of convergence in the payout rates chosen around the “5 percent solution”? Why do all the arguments for higher payout rates appear to carry so little weight? Are there other considerations, not described above, that foundations weigh in setting a paying out rate?

III. Obstacles to a more differentiated approach to the payout puzzle

In seeking explanations for the strange convergence of private foundations around a single solution to the payout puzzle, it is tempting to say that the arguments for the minimum rate are simply stronger than those for a higher rate. This position does not, however, seem compelling enough to explain the level of homogeneity in foundation behavior that we observe over time. We believe there are at least three significant obstacles to a more differentiated approach to the setting of foundation payout rates: (1) managerial constraints and incentives within foundation boards and staff; (2) conceptual obstacles to properly framing the problem; and (3) current tax treatment of foundation investment income. We take up each of these issues in turn.

A. Managerial Constraints and Incentives

As foundations deliberate over the question of how much they should payout each year, a set of potentially significant constraints stemming from the nature of agency impose themselves. The constraints were aired during a series of focus groups we held to discuss the factors that foundation managers weigh in making the payout decision. We met with trustees, presidents and financial managers in focus groups in Boston, San Francisco, Minneapolis, and New York.

When asked about what obstacles, if any, there were to higher payout rates, one trustee noted that that there is a clear disincentive to high rates of grant spending because it is often very difficult to measure the impact of grants, particularly compared to the rate of return on the portfolio and the growth of the endowment. Faced with committing resources to an activity whose “social return” cannot be precisely quantified or to growing an endowment and carefully tracking financial performance, trustees tend to gravitate toward the latter. One trustee explained that it is very hard to understand the claims and arguments of professional staff about the effectiveness of grants made by his foundation. On the other hand, the performance of the financial managers is extremely easy to measure with benchmarks and industry averages. This tendency may in part be due to the fact that many trustees come from backgrounds in business and law, rather than from nonprofit organizations. Given their stewardship roles, it is hardly surprising that many foundation trustees focus their attention on what they understand and what they can measure. In many foundations, there may thus be an asymmetry in the ability of principals to assess the performance of their grantmaking and financial agents. This naturally leads trustees to focus on performing well in the area of portfolio return and asset growth where success and failure are clearly measured.

Another consideration weighing on foundations is the social structure of philanthropy today. Prestige and privilege within philanthropy is accorded to foundations based on their assets size and perceived power. There is therefore a strong impetus to growing the endowment of a foundation as a tool of building the visibility of the institution within the national philanthropic community. Large foundations dominate the media presence of philanthropy and bring to their trustees considerable visibility. Moreover, size of endowment is usually one of the very first questions that foundation trustees are asked when they are in meetings with other trustees at conventions and meetings. Because assets are closely correlated to power, trustees admit a tendency to wanting to grow their foundations. Trustees pursue asset growth and financial performance because the role of boards demands that the trustees watch out for the long term institutional well-being of the foundation above all else, especially when their status is closely connected to the financial position of the institution they represent.

Size also brings with it the ability the pay staff higher levels of compensation, which may also influence payout decisions. One recent study found that foundations with endowments of over $1 billion paid their presidents on average $350,000, while foundation with endowments of $100 million only paid their chief executives on average

$120,000. A strong correlation between asset size and staff pay introduces an incentive within the staff to go along with the tendency of many foundation boards to payout close to the minimum required by law. While foundation staff might want to advocate on behalf of higher payout rates so as to have more money to disburse to grantees, staff also have vested interests in the long term growth of their foundations. This incentive is especially acute given the professionalization of the field and the emergence of grantmaking careers over the past three decades.

Convergence around a five percent solution is also a function of the growing weight of professional experience and tradition. Several trustees reported keeping their foundations close to the minimum payout number in part because most other foundations have made this same decision. At some foundations, there is limited time at board meeting to accomplish a long list of administrative functions. Setting time aside for a discussion of the payout question is not a high priority because a simple solution is present, which is to do what foundations have traditionally done. Convergence around a single solution to the payout puzzle thus appears to be a function at least in part of competing priorities within foundations and the perceived presence of field-wide norms. Challenging the field's settled practices requires that foundation trustees work hard not just to change an internal policy but also demonstrate that there is reason to do something different than other foundations.

B. Conceptual Obstacles

A second and potentially more potent explanation for the observed convergence in foundation payouts comes down to a simple obstacle to thinking systematically about philanthropic strategy. Trustees admit that the important problem of how foundations should value and discount the costs of creating social benefits over time is difficult to conceptualize and operationalize. Perpetuity often is a default position that removes the payout issue from active discussion and that makes paying as little as possible a natural first instinct. The absence of a well-defined time horizon for the accomplishment of the mission is symptomatic of a deeper issue facing foundations, namely the difficulty of developing and applying a discount rate to guide philanthropic decision making.

Discounting can be an important focusing device for foundations that pay out philanthropic funds over time, a device that draws attention to the complex time dimension in philanthropy. In principle, discounting would allow a foundation to measure how much future giving will cost in today's dollars. The rationale for discounting in philanthropy is simple: Discounting recognizes that all asset allocation decisions have opportunity costs. To make informed decisions, be they financial or philanthropic, alternatives need to be known and understood. Foundations, formally or informally, routinely evaluate competing grant requests to determine the "best" possible allocation of the limited pool of grant money available. If carried out, the practice of discounting would simply extend this notion of opportunity costs to broader allocative decisions over time in a systematic and rigorous manner. Unfortunately, important difficulties stand in the way of foundations actively applying discounting to their grantmaking.

What would discounting do for foundations if they practiced it? While compounding tells us what investment funds will be worth in the future given a set of assumptions about rates of return, discounting tells us what grant funds at some point in the future are worth today, based on those very same assumptions (Brealey and Myers 1999). Discounting captures the importance of time in shaping the choices we face about how to use limited resources. It is the best means to confront systematically difficult questions about inter-temporal choices that are wrapped up in many of the most significant business and government decisions (Dasgupta and Heal 1974). As one contemplates how to use philanthropic resources over time, discounting reminds one that the competing claims of future generations need to be weighed against those of the current generation (Lind 1994; Weiss1989).

One critical consideration when weighing the value of a future philanthropic dollar against a current philanthropic dollar is the selection of an appropriate discount rate. The higher the discount rate, the greater the opportunity cost is of spending today rather than in the future. Conversely, when the discount rate is low, future philanthropic giving appears to cost closer to the same as giving today. Since philanthropy prides itself on tackling difficult social problems that require sustained intervention and support, foundations often must work systematically on complex social problems over long periods of time. As they do so, foundations should place their philanthropic decisions in a framework that includes some notion of discounting over time. Given the fact that foundations are largely established in perpetuity and thus have responsibilities that span several generations, the selection of an appropriate philanthropic discount rate soon turns out to be a crucial question.

Holding all else constant, a foundation might begin its search for a philanthropic discount rate by looking to the rate that it would earn from its financial investments. Why is the rate of return on financial investments relevant to the discount rate? Because the financial rate of return earned by an endowment tells us what productively invested funds not donated today will be worth in the future. Any funds not paid out today will instead be invested in a financial account where they will earn the financial rate of return. The opportunity cost of making the grant today rather than the following year is thus the foregone return that the retained funds would have earned. But the challenge of discounting in philanthropy is much more complex than this and the difficulties mount as the other factors need to be added to the calculation.

Since the expected rate of return varies dramatically depending on how much risk one is willing to assume, it should come as no surprise that the discount rate would be different for different foundations. Some foundations have a higher tolerance for risk in pursuit of higher rates of return, while others have low appetite for risk. The lower bound of the discount rate, one that has almost no risk and thus provides a very conservative estimate of the value of the future dollar, is the interest rate on long-term U.S. government bonds. Given the fact that most foundations are willing to assume some risk in their investments, the actual discount rate can be calculated by taking a weighted average of expected return from stocks and bonds.

This basic philanthropic decision about the comparative value of giving now or later is complicated by three factors. First, foundations may not know for certain what rate of financial return they can reasonably expect in the coming years and decades. Second, they do not know the extent to which the social problems on which they choose to focus will become exacerbated or attenuated as a result of foregoing acting immediately. Third, they do not know how the cost of administering and implementing nonprofit services will evolve over time.

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Insert Figure 3 about here

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Like all actors facing a difficult intertemporal decision problem, foundations seeking to discount their giving would have to rely on reasonable simplifying assumptions: namely that financial markets will continue to perform as they have historically done, that social problems will evolve as they have over time, and that program costs will rise modestly like everything else. We know, for example, that institutional portfolios with an asset composition of 60:40 between stocks and bonds have delivered an average return of 10.5 percent per year over the past twenty years. We also know that many of the most pressing social problems are rarely subject to sudden reversal or dramatic decline. Finally, while there is no "donor price index" that can easily be consulted, the costs of delivering services in the nonprofit sector have not evolved demonstrably differently from those in the broader economy. Of course, some program costs have risen faster than others, some social problems have receded, while others have become exacerbated, and some institutional portfolios have performed exceptionally well, while others have languished. On the whole, however, the past gives foundations a reasonable point of departure for thinking about how the context for philanthropy will evolve over time. Only by making reasonable simplifying assumptions can foundations begin to see the immutable fact that philanthropic funds spent in the present need to be valued differently than funds spent some time in the distant future.

If it could be understood and applied, even roughly, discounting could redirect philanthropic energies to the core intergenerational questions posed by foundation philanthropy and would lead to a much more varied set of payout policies. The convergence around the minimum five percent payout is fairly convincing evidence, however, that few foundations are engaging in discounting when the determine their payout rate. If foundations were able to weigh competing claims on their resources more rigorously, the tremendous diversity of missions and purposes would lead to a vast array of strategically appropriate solutions to the payout puzzle.

C. Distortion Introduced by Excise Taxes

The internal logic of foundation decision making is not the only issue pushing these institutions toward convergence in payout behavior. Instead, tax policy is driving the unnatural convergence of foundations and depressing foundation payout rates in the process. Current tax policy toward foundations is strangely structured so as discourage deviations from long-term averages. Foundations that increase their payouts for one or more years above 5 percent, then later return to 5 percent are substantially penalized under the existing excise tax policy. This policy makes it hard for foundations to overcome the inertia they face in the payout arena, even when financial returns might tempt them to increase their payout rate.

An excise tax on foundations was first imposed on foundations in 1969 to recover the cost of government oversight of foundations' activities and was set at four percent of annual net investment income, which includes interest, dividends and net capital gains from foundation assets. Over time, the tax generated more income than predicted. In 1978, the excise rate was reduced to two percent of net investment income for all foundations, but receipts from the tax still far exceeded the actual monitoring expenses.

Thus, in 1984, the Deficit Reduction Act created the current excise tax structure that allows certain foundations to qualify for an even lower tax rate if they exceed their prior five-year average payout rate. It was expected that the two-tier tax structure would provide tax savings, and more importantly, adequate incentive to foundations to boost spending for charitable activities. The total receipt from the excise tax on net investment income of private foundations was over $430 million in 1998.

Today, the tax on the net investment income (NII) of a private foundation is two percent unless it meets one the following distribution requirements in which case the tax is reduced to one percent:

a) The foundation makes qualifying distributions during the tax year equal to the sum of the assets of the foundation multiplied by the average percentage payout for the base period plus one percent of the foundation NII for the tax year. The base period is understood as five years previous to the current tax year. If under any of these previous five years the foundation paid one percent of tax this tax will have to be deducted from the qualifying distributions of that year in order to calculate the average payout ratio.

b) The foundation was not liable for Chapter 42-excise tax for any of the base periods.

Mathematically the condition in part (a) may be expressed as follows:

If $Asset_n$ be the asset (in dollars) in year n,

NII_n be the Net Investment Income in year n,

QD_n be the Qualifying Distribution in year n,

$excise_n$ be the excise tax rate (1% or 2%) in year n,

and if the current year is represented as 0 and prior year by -1, -2, …, -5, then $excise_0$ = 1% if

$$QD_0 \geq \frac{\sum_{n=-5}^{-1} adj\_payout_n}{5} Asset_0 + 0.01NII_0$$

$$where \quad adj\_payout_n = \begin{cases} \dfrac{QD_n - 0.01NII_n}{Asset_n} & if \;\; excise_n = 1\% \\ \dfrac{QD_n}{Asset_n} & if \;\; excise_n = 2\% \end{cases} \qquad for\; n = -5, -4, \ldots, -1$$

How might the excise tax affect foundation payout behavior? Consider a foundation that has paid five percent of assets in qualifying distributions (the minimum required) and paid a one percent excise tax on NII in the prior five years, -5 through -1. The foundation has earned a NII of ten percent of assets during the current year (year 0) and has to make decision about the amount to be paid out as qualifying distributions. In future years, starting the following year (year 1), the foundation expects to earn NII at the rate of ten percent of assets[1] and plans to maintain the same five percent payout rate every year.

Now focus on a first case. Suppose the foundation decides to make the minimum required qualifying distributions, paying out five percent of assets in the current year. This will allow it to meet the one percent excise test in the current and future years as long as it does not deviate from the five percent payout rate. Table 1 shows the foundation's payout rate and NII rate, as well as the excise tax paid over the past five

[1] Based on a total historical return of 11.5% for a typical portfolio (of 60% in stocks and 40% in bonds), 10% is a reasonable estimate for net investment income.

years and the future five years along with the current year. We have assumed that the starting assets of the foundation five years ago were $100 million.

Next, suppose that for the current year *only*, the managers are considering increasing the payout rate to 5.01 percent, a one basis point departure from their usual five percent rate. This would be a one-time small increase from the five percent payout rate followed by a reversion to the usual five percent rate in future years. Table 2 shows that this increase in the payout rate will still allow the foundation to pay only one percent excise tax in the current year but will increase the threshold that it has to meet in future years' payouts. If the foundation continues to payout only five percent in subsequent years, it will fail to meet this threshold, thereby doubling its excise tax rate to two percent of NII *in each and every year* in the future.

Thus the excise tax rule penalizes the foundation if it *increases* the payout rate by even a small amount by making it liable to the higher rate of two percent. Not only does the higher rate increase the tax liability, it also reduces the rate of growth of foundation assets thereby substantially reducing the amount paid out in qualifying distributions in the future. How large is the cost of a one-time increase in qualifying distributions by a mere 0.2 percent (from 5.00 percent to 5.01 percent of assets)? Table 3 provides the answer as a function of the discount rate.

If one feels that the appropriate rate to discount future cash flows is seven percent per annum, Table 3 shows that the 0.2 percent increase in qualifying distributions in the current year would reduce the total amount paid out in qualifying distributions by almost four percent over the (infinite) lifetime of the foundation. Assuming a current total asset base of $400 billion over all foundations, this would translate into a reduction of almost

$33 billion in qualifying distributions, in present value terms. The amount paid in excise tax to the government would go up by a whopping 96 percent!

It is important to note that while the dollar amount paid out in excise taxes is small, most foundations would prefer to devote their spending to making qualifying distributions rather than to meeting higher tax liabilities. A foundation that pays the higher two percent excise rate might even be perceived by other as inefficient. Our conversations with foundation managers suggest that they make their spending decisions in a manner so as not to be saddled with the higher excise rate in the foreseeable future. The only way to do this is to increase the payout rate *only* when foundation managers are certain that they will be able to sustain the higher payout rate forever. In the face of large uncertainties both on the financial and grantmaking side of foundation activities, this is clearly an onerous burden that few foundation managers are willing to bear. Therefore, it may not be surprising that many foundation managers prefer not to depart from the minimum payout rate even if the current year has experienced a sharp growth in assets or presents exceptional grantmaking opportunities.

The adverse impact of the two-tier excise tax has been noted in the proposed Budget of the US government for the fiscal year 2001. One proposal under consideration would reduce the excise tax on private foundation net investment income to a flat rate of 1.25 percent and the formula for the special reduced excise tax rate for foundations maintaining their historical charitable level of distributions would be repealed.

IV. Policy Options

In thinking about what public policy toward foundations should be, two objectives seem clear and indisputable. First, public policy should be demanding enough to ensure that foundations use their resources in ways that benefits the public, not just themselves. Second, public policy should be flexible enough to allow foundations to select a payout rate that is strategically aligned with their missions. The existing payout policy fails in both these tasks: Foundations assets have grown substantially over time and convergence around the minimum payout rate is widespread. By way of conclusion, we explore the tradeoffs required to reform public policy toward foundations.

A first rationale for a minimum foundation payout rate is the encouragement of a steady dispersal of philanthropic funds to the nonprofit community. This rationale flows from the tax-exempt status granted to foundations and the ability of donors who establish foundations to avoid substantial estate taxes. In exchange for their privileged tax status, foundations are required to make disbursements that benefit charitable organizations. The five percent flat rate has only been marginally successful in ensuring this transfer, however. Foundations have earned much higher rates of return on their assets over the past 30 years, and many have been able to grow their endowments significantly during this time. Looking beyond the current payout policy, there are several ways to ensure that this transfer of resources is accomplished, ways that would do a more thorough job of moving philanthropic funds into the community.

Perhaps the most obvious alternative is an inflation adjusted variable payout rate keyed to foundation asset growth or a variable rate keyed to asset growth that is both adjusted for inflation and based on the average rate of return over several years. A variable rate would clearly be more effective than the current flat rate at pushing foundation resources into the nonprofit world -- without threatening the ability of foundations to exist in perpetuity. While it would ensure that foundation asset growth is applied to giving, not growing beyond inflation foundation endowments, it is not clear that this policy option would be appreciably better than the current flat rate. In large part this is because foundation payout policy should do more than just ensure that funds flow into the nonprofit sector. Public policy needs be flexible enough so as to encourage foundations to adopt a plurality of payout rates that are strategically aligned with the distinctive missions of individual foundations. While a variable rate would lead foundations to pay out more funds, it would do nothing to encourage foundations to link their grantmaking and financial strategies.

This brings us to the second important criteria for judging payout policies, namely, the degree to which the policy encourages foundations to choose a rate that represents the most effective way to accomplish the varied missions defined by foundations. The fact that there is such homogeneity in payout practices would not be troubling if all foundations had identical missions and if 5 percent represented the right payout rate for all foundations at all times. However, it is very difficult to argue that this is the case. In reality, foundations are committed to many purposes and causes. Because missions vary among foundations, the convergence of foundations around a five percent payout policy suggests that there may be little of no alignment between the financial and grantmaking strategies of foundations. If foundations were indeed matching their payout rates to the nature of their missions and the shape of the social problems on which they are focused, one would expect to find a broad plurality of solutions to the payout puzzle, ranging from very conservative strategies to much more aggressive ones. We therefore hold that the current policy treatment of private foundations is flawed because the convergence it has introduced into the field has made strategic alignment between financial and grantmaking strategy hard to achieve.

While many of the possible alternatives to the five percent rate are possible, only one of these options would clearly encourage foundations to adopt a payout rate that strategically links mission and payout decisions within foundations. This option is nothing other than the elimination any and all mandated payout rates. If there were no mandatory payout rate, all foundations would be forced to engage the question of what rate is strategically desirable. It would remove the target and default position that existing policy have created and free foundations to engage the payout decision fully. Eliminating payout regulation would surely push foundations to think through more fully the payout puzzle. It would also likely lead to a more diverse set of solutions over time, as the grip of tradition loosens and as foundations begin to confront the challenge of making difficult intertemporal tadeoffs. Such an approach would not be entirely unproblematic. One clear obstacle to a complete elimination of all mandated minimum rates is that the first rationale for public policy in this field would be difficult to achieve. Foundations might well respond to deregulation by reducing their payouts to levels even lower than those adopted over time. The cost of such a move in political terms would be high, as an increasingly organized and vocal nonprofit service community would surely demand redress.

How then can foundation policy be fruitfully reformed? A clear first step would be the elimination of the excise tax that distorts the incentives in the field. Beyond this obvious but limited first step, the choices become more difficult. On the one hand, adopting a variable payout rate would likely do a better job of ensuring that foundation resources are used for public purposes. On the other hand, abandoning payout regulation entirely might well encourage more pluralism and greater strategic alignment in foundation decision making. In making any change to existing policy, one thing must be kept in mind. Regulating foundation payouts involves tough tradeoffs. While it may be necessary for policymakers to choose between either encouraging foundations to increase the scale of their giving *or* allowing these institutions increased more freedom to pursue their missions, all parties to the search for a solution to the payout puzzle should be clear on one thing. The long-standing five percent payout requirement has failed in both these tasks.

Figure 1

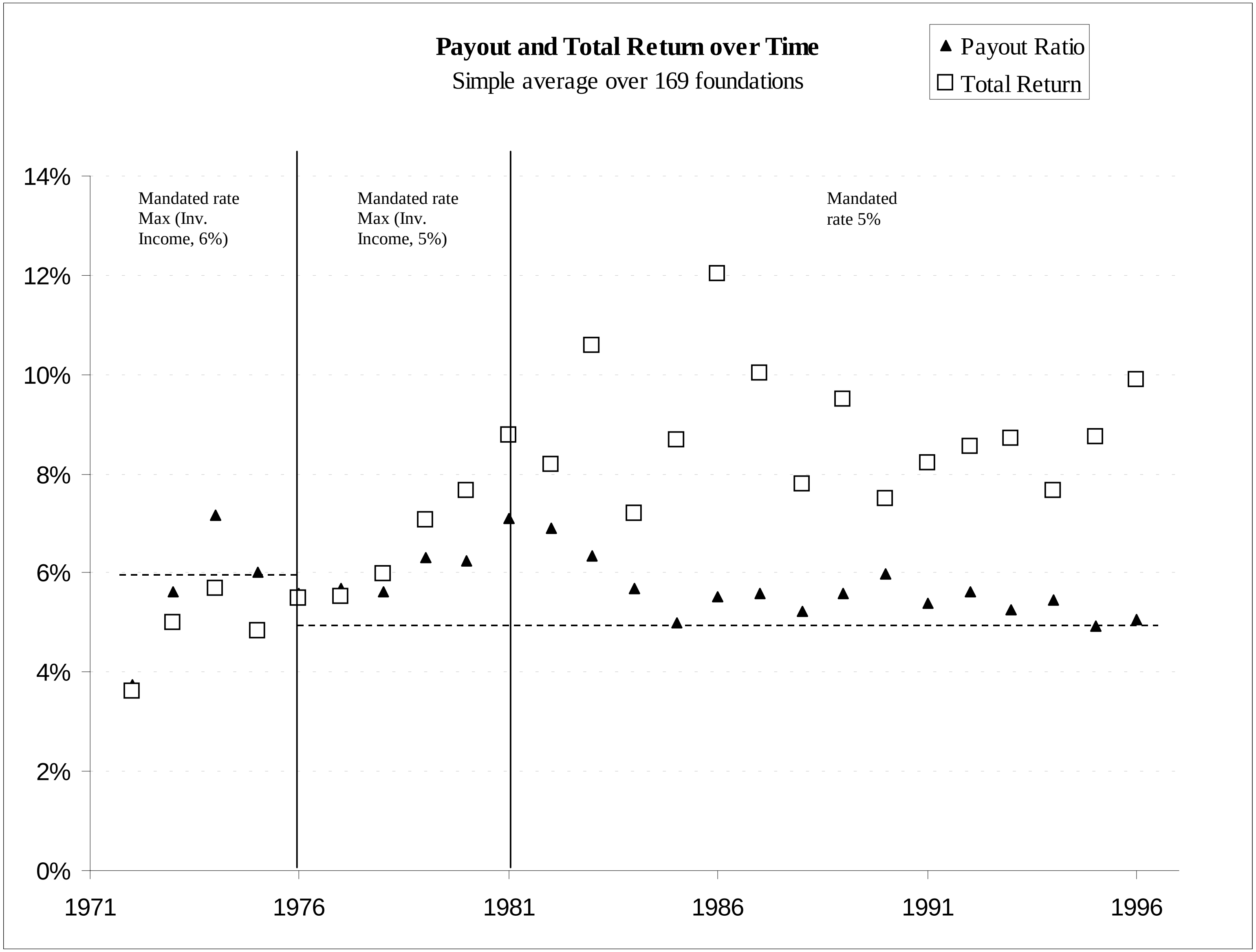
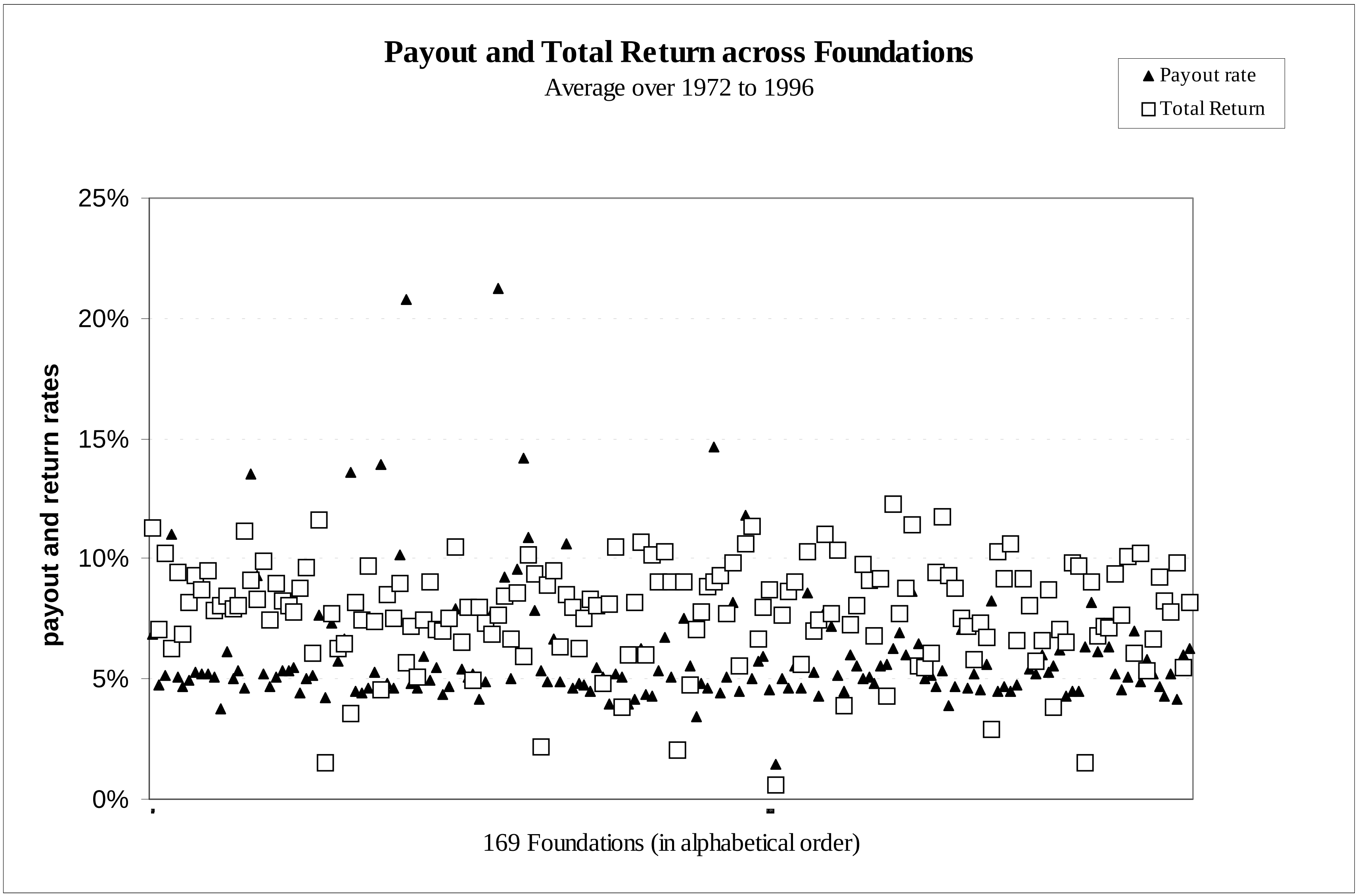

Payout and Total Return over Time
Simple average over 169 foundations
Payout Ratio
Total Return
Mandated rate
Max (Inv.
Income, 6%)
Mandated rate
Max (Inv.
Income, 5%)
Mandated
rate 5%
14%
12%
10%
8%
6%
4%
2%
0%
1971
1976
1981
1986
1991
1996

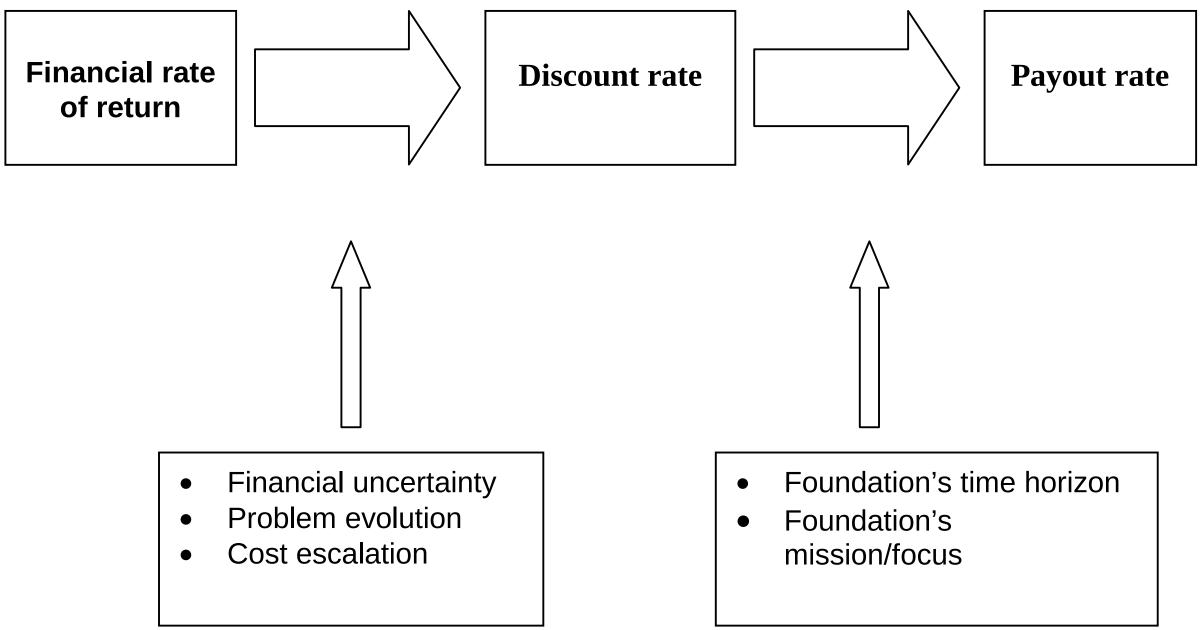
Figure 2



Payout and Total Return across Foundations
Average over 1972 to 1996
Payout rate
Total Return
25%
20%
15%
10%
5%
0%
payout and return rates
169 Foundations (in alphabetical order)

Figure 3

The financial rate of return, the discount rate, and the payout rate in philanthropy



Tables 1-3 Effects of Excise Tax on Foundation Payouts

Table 1: Paying out the minimum payout rate of 5% every year

Year	-5	-4	-3	-2	-1	0	1	2	3	4	5
NII rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Payout rate	5.00%	5.00%	5.00%	5.00%	5.00%	**5.00%**	5.00%	5.00%	5.00%	5.00%	5.00%
Starting assets	$100.00	104.40	108.99	113.79	118.80	124.02	129.48	135.18	141.13	147.33	153.82
NII	$10.00	10.44	10.90	11.38	11.88	12.40	12.95	13.52	14.11	14.73	15.38
Ending assets before payout & taxes	$110.00	114.84	119.89	125.17	130.68	136.43	142.43	148.69	155.24	162.07	169.20
Excise tax rate	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
Excise paid	$0.100	0.104	0.109	0.114	0.119	0.124	0.129	0.135	0.141	0.147	0.154

Table 2: Increasing the payout rate to 5.01% *in year 0 only*

Year	-5	-4	-3	-2	-1	0	1	2	3	4	5
NII rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Payout rate	5.00%	5.00%	5.00%	5.00%	5.00%	**5.01%**	5.00%	5.00%	5.00%	5.00%	5.00%
Starting Assets	$100.00	104.40	108.99	113.79	118.80	124.02	129.47	135.03	140.84	146.90	153.21
NII	$10.00	10.44	10.90	11.38	11.88	12.40	12.95	13.50	14.08	14.69	15.32
Ending Assets before dist & tax	$110.00	114.84	119.89	125.17	130.68	136.43	142.41	148.54	154.92	161.59	168.53
Excise tax rate	1%	1%	1%	1%	1%	**1%**	**2%**	**2%**	**2%**	**2%**	**2%**
Excise paid	$0.100	0.104	0.109	0.114	0.119	0.124	0.259	0.270	0.282	0.294	0.306

Table 3: Cumulative Effect of a onetime increase of 0.2% in qualifying distributions

Discount rate	5%	6%	7%	8%	9%	10%
Change in present value of all future qualifying distributions	-14%	-6%	-4%	-3%	-2%	-2%
Change in present value of all future excise taxes payments	71%	88%	93%	95%	96%	96%

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